APPENDIX

NOTES FOR F.O.M.C. MEETING
October 5-6, 1981

Sam Y. Cross

Mr. Chairman, the two main developments in the exchange markets since the Committee's last meeting have been, first, a substantial downward adjustment of the dollar, and, second, a realignment of the currencies in the European Monetary System, announced October 4.

With respect to the dollar, a peak in the rate was reached August 10, a week before your last meeting, when the dollar traded at 2.57 DM. During the subsequent six weeks, the dollar declined by about 15 percent to 2.23 DM, with much of the decline concentrated in relatively brief periods, and then rebounded a bit.

Market sources cite several closely related factors as contributing to the dollar's decline.

First, the dollar had appreciated particularly rapidly in early August and there was a widespread perception that a correction might be coming, particularly since the dollar had been rising for a year and there were doubts that it would go much further.

Second, sentiment toward the dollar weakened, as the euphoria over the Administration's impressive performance in its tax and expenditure cuts gave way to second thoughts about the fiscal deficit.

Third, short-term interest rate differentials favoring the dollar narrowed. U.S. short-term rates eased and the market felt that the Federal Reserve might be forced by softness in the economy and political criticism to weaken its monetary restraints prematurely. By contrast, at least some European countries (Switzerland, U.K.) moved forcefully to raise interest rates to contain inflation and bolster their currencies.

Fourth, sentiment toward the DM strengthened, as balance of payments prospects for Germany appeared to be improving and optimistic forecasts were widely broadcast by German leaders. At the same time, the United States was expected to slide into current account deficit in 1982.

And, fifth, with Germany's financial prospects improving and France's deteriorating, the EMS came under heavy strain and the EMS central banks chose to sell large amounts of dollars to maintain the EMS margins.

The French intervened heavily to blunt several bouts of speculation against the franc, bringing net official currency sales since the beginning of May to more than $11 billion equivalent. But by comparison with the intervention of last spring, the French authorities relied more heavily on selling of dollars rather than selling of marks. Since the Committee's last meeting, France sold net in dollars, while about equivalent of German marks were sold to support the French franc.

The EMS realignment of a 5.5 percent appreciation for Germany and the Netherlands, and a 3 percent devaluation for France and Italy, should help deal with strains among those currencies. There was some questioning in the market as to whether a 3 percent move in the French franc would be sufficient, but the upward adjustment of the DM was more than expected. The French authorities were encouraged that immediately the German mark fell close to the bottom of the new EMS band and the French franc moved to the top. Large reflows did not immediately materialize, however, and it may be that the market is waiting to see what measures the French government will introduce on Wednesday to follow up on the realignment. The Belgian franc, which had been extremely weak, did not devalue with the French. The answer given was that the present caretaker government had not the authority, and any decision would have to await the November 8 Belgian elections. Initially anyway, the Belgian franc has been trading comfortably around the middle of the EMS band, taking some benefit from its de facto downward adjustment against the mark and the guilder.

Outside the EMS, the U.K. was the principal seller of dollars since the Committee's last meeting. Sweden and Canada were net purchasers. All in all, net dollar sales by major foreign central banks totaled $2.3 billion. We did not intervene for Treasury or Federal Reserve account, though we intervened on many occasions as agent for Europeans.

With respect to the performance of the markets during this period, concern has been expressed by traders and others that the market has continued to be thin and volatile. We frequently hear comments about the lack of depth in the market, a condition which some say formerly occurred at particular times or in particular markets but which has now become quite commonplace. Quite apart from the question of central bank intervention, these professionals offer various explanations: 1) increased uncertainty about economic and political events; 2) greater interest rate volatility and a lack of depth in other financial markets; 3) increasing reluctance by major banks to make market, because of a perception of greater risk, and 4) improved communications and greater potential for bandwagon effects since all news now known instantly all around the world. They point out there are more and more market participants, as many corporations are establishing trading desks, but paradoxically thinner markets.

REPORT OF OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement:

Desk operations since the August meeting were conducted against a backdrop of persistent weakness in narrow money supply, leading to declines in adjustment borrowing at the discount window and a lower Federal funds rate. Growth in M2 remained fairly strong, however, especially after allowing for the effect of switches from time accounts into temporary holdings of retail repurchase agreements which are not currently counted in M2. Bearing in mind the strength of M2, there were no upward adjustments of the non-borrowed reserve path such as might have been made in light of the considerable shortfall in M1B, and hence of demand for total reserves, below their path levels.

In the first four-week subperiod, ended September 16, total reserves were about $200-300 million below path, while non-borrowed reserves were around $140 million below their path. Despite the shortfall in total reserves, adjustment borrowing averaged only $90 million below the initially assumed $1,400 million level in those weeks, in part because special factors contributed to heavy borrowing in the first week, and it was decided not to let this result in too abrupt a decline in borrowing subsequently. By the end of the first subperiod, expected adjustment borrowing had worked down to about $950 million, although actual borrowing levels tended to exceed the anticipated levels by a modest margin each week.

For the second subperiod, ending October 7, it is expected that total reserves will be about $380 million below path, while at this point we expect nonborrowed reserves to turn out close to path. Expected borrowing levels in the second subperiod hovered around $900 million, although once again actual adjustment borrowing tended to exceed anticipated levels modestly in the first two weeks of the subperiod.

In these comparisons, extended credit to thrifts has been counted as nonborrowed reserves. Such credits have built up more moderately than might have been expected, reaching a little over $400 million currently and chiefly reflecting loans to one institution.

As borrowings declined, the Federal funds rate worked lower, from around 18 1/4 percent in mid-August to an average of 15 percent in the final week of September. So far this week, the rate has averaged 16.67 percent, a rebound due largely to extra cautious bank behavior last Thursday and Friday in response to the October 1 switch to same-day settlement of the CHIPS clearing mechanism in New York.

Outright purchase and sale or redemption operations of the Desk were roughly a stand-off during the interval, and were almost entirely confined to bills. Around late August - early September, the System sold about $1.1 billion of bills to foreign accounts and ran off $500 million of bills to absorb reserves released by various market factors. Then from September 8 to 21, the System purchased about $1,750 million of bills, part of it to offset an enlargement in the pool of foreign repurchase agreement funds. In the last few days, we turned again to absorbing reserves through selling about $370 million of bills to foreign accounts. We also expect to run off some $200 million of bills in today's auction. System repurchase agreements with the market were employed just once, early in the period, although on several other occasions part of the foreign repurchase orders were passed through to the market. The System did some matched-sale transactions with foreign accounts each day and on several occasions with the market as well.

I would note two recent changes regarding valuation of securities for repurchase agreements. First, in view of greater market volatility, we have increased the margins taken, both for our own repurchase agreements and when we pass through foreign account funds--which in fact are also technically our own repurchase agreements since the New York Fed is an intermediary in those transactions. Second, in valuing collateral for foreign account repurchase agreements, we now employ the same technique as with our own repurchase agreements, which simplifies procedures for us and the dealers; it also has the effect that we need to leave some small part of the foreign repurchase pool to be arranged as matched sales with the System, even when passing through the bulk of those transactions to the market.

As the funds rate and dealer financing costs declined, msot short-term rates -- out to about a year -- also declined, although generally by less than the funds rate. In a sense this made up for the fact that funds had tended to decline only grudgingly earlier in the summer when some market rates had come down fairly smartly. Thus, while funds fell some 2-3 percentage points over the interval, most bill rates beyond two months were off more like 3/4 to 1 1/2 percentage points. Three- and six-month bills were each auctioned today at about 14.25 percent, down from 15.71 and 15.64 in mid-August. Supplies of 3-, 6- and 12-month bills were steadily augmented and there was about a $3 billion net rise in supplies despite a paydown of about that same size in cash mangement bills. Strong demand for commercial paper brought those rates down by 1 or 2 percentage points despite large increases in supply. CDs showed similar declines in rate while outstandings increased. The prime rate came down more modestly, by just one percentage point, to 19 1/2 percent, although a further dip to 19 gained momentum today. The banks seemed to be seeing plenty of loan demand without having to push ahead with rapid rate cuts.

The intermediate-and long-term markets, meantime, were a world unto themselves, with rate movements more like a roller coaster than an orderly marketplace. Daily moves of 2 or 3 points were not uncommon. On balance, longer rates rose over the period and the predominant mood of the markets was one of deep pessimism, occasionally interspersed with rallies that temporarily lifted prices, but not spirits particularly. The chief depressing force seems to have been the prospect of large and continuing Federal deficits. Every new Treasury offering reminded the market of its concerns, and even the Administration's strongly expressed determination to hold upcoming deficits to previously targeted levels seemed to be occasions for renewed skepticism in the market. Some market participants also cited the firm resolve of the money authorities to hold down money growth as an additional reason for expecting sustained high rates, although on the other side there were some who were concerned that the Fed might relax its restraint prematurely, which was also seen as leading to high or even higher rates because of greater inflationary expectations. The recent cut in the discount rate surcharge was not taken as an easing move and if anything seemed to generate some disappointment that the move was not larger.

The temporary rallies were supported by sporadic investment demand, perhaps induced by the development of a yield curve as that permitted intermediate and larger issues to be carried at a profit as fund rates and financing costs declined. News of weakness in narrow money growth and the real economy also gave support at times.

The Treasury raised some $8 1/2 billion through coupon issue offerings during the period, with most of the new issues setting records for their maturity areas. In fact, it was something of an event when the 2-year note auction in mid-September failed to set a record, as it yielded about 1/8 percentage point less than the 2-year note a month earlier. On several occasions, the market seemed to go into a free fall, as investors stood aloof and dealers were unwilling to take on supply except at very steep concessions. The hyper-cautious attitude of dealers has partly resulted from recent loss experience--which while it has not caused any failures, as the losses have occurred in firms that could afford them, has made dealer managements extremely edgy.

The most recent loop on the roller coaster has been upward in price, recouping some of the deepest losses, but it remains to be seen whether this rally is any better sustained than its recent predecessors.

On balance over the interval, yields on intermediate- and long-term issues were unchanged to about 1 percentage point higher. At its worst, the Treasury's 30-year bond touched a yield of 15.28 percent, while the current yield is about 14.60 percent.

The corporate sector also saw new yield records while new issue activity was sporadic and overall rather light as borrowers preferred to fund short, with bank loans or commercial paper. This was also true to some extent for tax-exempt issues although some of them have less flexibility to adjust maturities.

Finally, I should mention that in the Federal agency market, yield spreads against Treasury issues have receded somewhat, at least in part because FNMA issues, which spearheaded the widening spreads, are eligible as qualified residential financing investments for the proceeds of All-Savers Certificates.

James L. Kichline
October 6, 1981

FOMC BRIEFING

Incoming information on the economy indicates activity has weakened further in recent months. It now appears likely that real GNP will register small declines in both the third and fourth quarters of this year. The weakness of activity appears to be spreading, although the credit-sensitive sectors most clearly are in a state of decline. At the same time, there are not signs around at this point that the economy is headed into a tailspin; that would seem to require serious inventory imbalances or a collapse of consumer spending, neither of which is supported by the quantitative or qualitative evidence.

The labor market reports suggest demands for labor have been easing. In September, the unemployment rate rose 0.3 percentage point to 7.5 percent, with the rise in unemployment attributable to those who lost their last job. Payroll employment was about unchanged while the average workweek dropped appreciably, although some of the drop in hours reflects the occurrence of Labor Day in the survey week. Nevertheless, press reports of plant closings and shortened production schedules, along with the higher level of initial claims for unemployment insurance in recent weeks, provides persuasive evidence of a deterioration in labor market conditions.

Industrial production is now moving downward as well after having been on a plateau, or at best a very slow growth trend, from the early months of this year through July.

Production declined somewhat in August and a tentative reading for September suggests output probably dropped in the neighborhood of 1 percent further. To be sure, the exceptionally poor performance of the auto and construction industries remain the main generators of declines, but reports of weakness are becoming more widespread, and include household durables, textiles, chemicals, and other industrial supplies.

Both the homebuilding and automobile industries continue sick and are likely to remain so for some time to come. Housing starts fell below a million units annual rate in August, building permits moved lower, and new home sales dropped considerably further. The prevailing tight conditions in mortgage markets seem unlikely to change soon, given the financial assumptions of the staff forecast and our view that the All Savers Certificate will not significantly enlarge the supply of lower cost mortgage funds. Thus, housing starts are expected to remain below a million units on average this winter and turn up only a little later next year.

In the auto industry, sales picked up in August and early September in response to various sales incentive programs of domestic manufacturers; for the full month of September sales were at a 6.9 million unit annual rate, 1 million below the August rate. But these additional sales undoubtedly mortgaged the future, and we anticipate the fourth quarter sales picture will be poor. The auto manufacturers themselves are anticipating a slow period ahead and have cut their fourth-quarter production schedules to a low 6¼ million unit annual rate--about the same as that in September. Whether or not they will have to reduce these schedules even further seems to depend importantly on their pricing policy, with the high relative price of autos a principal impediment to an improved automobile market. There already has been some downward adjustment of previously announced price increases on 1982 models, and we could well see more of this in one form or another.

Consumer spending on goods other than autos has been sluggish in recent months and there is little reason to expect much change in the near future. Disposable personal income in the third quarter was boosted by the $15 billion annual rate increase in social security payments, and in the current quarter the personal income tax cuts will add a similar amount to income. However, the performance of stock, bond, and housing markets has adversely affected actual or perceived wealth and liquidity, and developments outside the consumer sector suggest employment growth will be slowing, which acts as a drag on gains in income. On balance we do not see the consumer sector as a dynamic near-term force in the economy, but rather believe consumers will strive to maintain their spending patterns in the face of reduced income growth--until being stimulated by the second and larger stage of personal income tax cuts in mid-1982.

Late next year we also are forecasting a turnaround in real business fixed ivestment outlays as sales rise and in lagged response to the business tax cuts.

For the period immediately ahead, however, it appears that fixed investment expenditures will be held down by the high cost of capital, disappointing sales and profits, and under-utilized capacity. The data on orders and contracts in real terms on average are supportive of some decline in investment expenditures in coming quarters.

Other sectors in the economy present a mixed picture on recent and prospective developments. Export growth has been slowing while import growth has picked up, both mainly a reflection of the higher value of the dollar; these trends, especially on the export side, are expected to continue. State and local government purchases turned down in the second quarter and appeared to have dropped further last quarter; we anticipate state and local outlays will remain damped over the forecast period in association with the tight budget situation given cutbacks in federal grants and aid. In the federal sector total purchases are projected to continue rising, driven principally by the buildup of defense outlays.

Overall, the staff forecast entails a weaker current quarter performance of real GNP than envisaged at the time of the last meeting of the Committee, but no fundamental change in what was and continues to be a view of sluggish activity through mid-1982. It is expected that the unemployment rate in that environment will move into the 8 percent area. At the same time, further progress should be experienced on the inflation front. In coming months food and energy prices are unlikely to perform as well as they did in the spring and summer, but we don't appear to be in for major surges in view of good harvests and the problems confronting OPEC. More important, however, the underlying conditions are in place to experience improved behavior of other prices and wages, and we expect the fixed weight deflator to be rising around 7 percent later next year.

FOMC Briefing
Stephen H. Axilrod
October 6, 1981

One policy option before the Committee today is to aim at bringing M1 up to the lower limit of its longer-run growth range by around year-end, requiring about a 12 percent annual rate of growth over the last three months of the year. Another option is to permit M1 to remain well below its longer-run range, while concentrating on keeping M2 around the upper limit of its range (after due allowance for distortions from the all savers certificate). In that context, I don't intend again to present the Committee with the full range of by now well worn arguments about whether M1 or M2 under current circumstances should be given more or less weight in policy decisions. But it might be useful to examine the extent to which the behavior of M1 and M2 for the year to date might be said to represent more or less restraint or ease than the Committee bargained for when it set the long-run targets for the year.

In a basic sense, that would depend on economic developments compared with what the Committee might have hoped for. Price performance seems to be in line with Committee members expectations about the GNP implicit price deflator as indicated in the mid-year report to Congress. Real GNP, on the other hand, seems to be on the weak side of mid-year expectations--which might argue that the aggregates have led to more restraint than the Committee anticipated (though not necessarily more than would be considered temporarily acceptable). At the time of the mid-year report to Congress, the range of Committee expectations for real GNP for the year 1981 was for increases in a 1 to 3½ percent range, and the staff's projected outcome is now about 1 percent.

The developing restraint on real economic activity and the encouraging behavior of prices probably reflects in some significant part the impact of the sustained, quite high levels of real short-term interest rates this year--as they affected, among other things, the housing market, inventory policies, and commodity prices. This high real level of short-term rates in its turn reflects, at least in part, efforts to restrain M2 growth.

In the degree that M2 is given more weight in policy implementation, it probably involves the likelihood of rather large and prompt movements of interest rates, given structural changes in the asset composition of M2 that have greatly increased the weight of assets that bear either a market interest rate or are subject to variable ceiling rates kept closely in line with market rates. By August of this year, such assets represented 56 percent of the nontransaction component of M2 (which is the bulk of M2), up from 41 percent in mid-1980, 17 percent in mid-1979, and a mere 1 percent in the middle of 1978.

As a result of this virtual revolution in the structure of finance--and one that is continuing--an effort by the Federal Reserve to restrain M2 entails in the process an offsetting effort by depository institutions to raise offering rates on deposits or other liabilities as market rates rise. In the degree that they do so, further restrictive pressure is exerted on those assets--such as M1--whose interest rates do not vary with market rates and which, in the present institutional setting, are more directly affected through control over reserves. Market interest rates then rise even further than they otherwise would, as M1 growth is restrained--and, this year, reduced below target.

All of this suggests that the tendency for M2 to run at or, depending on how you evaluate retail RPs, above its longer-run range this year did not mean that the Committee was somehow attaining less restraint than it bargained for. Indeed, it might have been attaining more. Financial evidence for that would have been in the rather unexpectedly high, sustained level of real short-term interest rates and in the weakness of M1.

I would not at the same time, however, read all of the weakness in M1 relative to path as suggestive of additional restraint. There does appear to be a greater downward shift in M1 demand (relative to income and interest rates) in process than was contemplated earlier in the year, as the public become increasingly disenchanted with cash as an asset for transactions or precautionary purposes. Thus, some, if not most, of the emerging weakness in M1 would have needed to have been accommodated in any event in order to have avoided less restraint on the economy than the Committee wanted.

A few summary observations related more specifically to today's Committee decision about policy over the balance of the year can be offered, based in part on this recent experience.

First, sufficient downward shift in demand for M1 has probably already occurred, not to mention the probability of some further shift in the coming months, to make an effort to raise this aggregate to the bottom of its longer-run range economically unnecessary in terms of the Committee's original intentions. Moreover, an extremely rapid rebound in M1 might well worsen inflationary expectations.

Second, a tendency for M2 to move above its long-run path (apart from ASC-related developments) might need to be expected over the next few months possibly in response to some at least temporary rise in saving from the tax cut and partly in response to any rebound in demand for its M1 component relative to income.

Third, the rapid changes taking place in financial structure obviously complicate the interpretation of the behavior of M1 or M2, and for this if no other reason, the Committee would need to evaluate the significance of accompanying changes in short-term market rates--with the odds on declines in rates over the period ahead having greatly increased in recent weeks. If such declines seem to entail very low real rates at a time when the Committee judges that pent-up demands for goods are strong, then the reduction in rates risks a later monetary explosion, somewhat like the latter half of 1980, and threaten progress made in curbing inflation. On the other hand, if low real interest rates emerge when businesses and consumers have a basically weak propensity to spend then these low short-term rates are not so likely to stimulate a subsequent excessive monetary expansion--or, to peek behind the veil of money, to set up conditions that would reduce the odds on achieving the more moderate wage settlements next year that are needed to maintain forward momentum in the process of reducing upward pressures on prices.